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C O N F I D E N T I A L SECTION 01 OF 02 SOFIA 000731

SIPDIS

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TAGS: ECON EFIN PGOV BU
SUBJECT: BULGARIA: FULLY COMMITED TO THE CURRENCY BOARD

REF: SOFIA 679

Classified By: Ambassador Nancy McEldowney for reasons 1.4 (b) and (d)

¶1. (C) Summary: Bulgaria remains fully commited to the currency board and has no exit strategy from the CB arrangement besides Euro adoption. If the board comes under pressure, officials here expect to see a process of market-driven euroization rather than a move away from the fixed exchange rate. While such a move would cause consternation within the European Central Bank, the Bulgarians believe choosing such a course would be better than the instability caused by a forced move to a floating exchange rate. The Bulgarians remain confident their policy of fiscal conservatism will provide sufficient buffers to survive the financial crisis. End Summary.

BANKING SECTOR STRONG; FDI AND GROWTH DOWN

¶2. (C) In a series of meetings with Treasury and Embassy representatives November 17, Bulgarian Central Bank and Ministry of Finance officials reiterated the country's strong commitment to the currency board and stressed cautious optimism about their chances to weather the current global financial crisis without major upheaval. The mostly foreign-owned banking sector continues to post impressive profits, which parent banks have pledged to continue to reinvest in Bulgaria for now. Capital adequacy ratio is at 14.6 percent, well above EU averages, while the loan-to-deposit ratio is 123 percent. Non-performing loans remain low at 2.03 percent. Because interbank lending remains tight, some officials, such as the head of the Deposit Guarantee Fund, are suggesting the introduction of interbank lending guarantees and the lowering of reserve requirements (now at 12 percent), but the Central Bank has not yet determined if such measures will be necessary.

¶3. (C) Forecasters do expect a significant impact on the real economy in terms of reduced FDI and lower growth (reftel). FDI, which reached more than six billion euros in 2007, is down by one billion euros year-on-year for the first nine months of 2008, largely due to a slow-down in investment in construction and real estate. The Bulgarians hope that reduced FDI will eventually narrow the country's high current account deficit (expected to be 24 percent of GDP in 2008). To compensate for expected reductions in private investment, the GOB plans to invest 7.6 percent of GDP of next year's consolidated budget in large public infrastructure projects.

No CB Exit Strategy

¶4. (C) The Bulgarians say the currency board arrangement, put in place after a catastrophic banking crisis in 1997, has served them well. The currency board has large buffers,

including 14 billion euros in foreign exchange reserves and six billion euros in fiscal reserves, which could help it withstand a hypothetical run on the lev. Our Bulgarian interlocutors ruled out the adoption of a floating exchange rate in the event of a more prolonged speculative attack on the board. The only exit strategy in place is the adoption of the euro -- currently a sensitive topic. In 2006-2007, the Bulgarians pushed hard to join ERM-II as soon as possible. Bulgaria managed to meet four of five criteria for membership (persistent high inflation kept them out) and they were urging a more lenient attitude on the part of the ECB on these criteria. Talks with the ECB on ERM-II membership broke down unexpectedly in December 2007, according to Khalin Hristov, adviser to the Central Bank Governor. Bulgaria has now been instructed by the ECB not to attach a date on ERM-II or Eurozone membership, which has caused much anxiety within the halls of the Bulgarian Central Bank. "We don't trust them anymore," advisor Hristov said of the ECB.

¶5. (C) According to Hristov and the head of UnicreditBulBank Levon Hampartzoumian, if the currency board comes under sustained outside attack, Bulgaria would likely choose market-driven euroization over a move to a floating exchange rate. With 55 percent of deposits, 47 percent of mortgages and 70 percent of corporate loans already euro-denomiated, the euro is already increasingly becoming the currency of choice. Euroization would go against EU rules, but our contacts say Bulgaria would see this as the lesser of two evils if it had to choose between "saving the economy" and following ECB rules. Bulgaria hopes the current financial crisis will make the ECB realize it has more to gain than lose from allowing early euro adoption. Echoing this

sentiment, Deputy Finance Minister Lubomir Datsov predicted that talks on ERM-II for Bulgaria would resume in the next few months, hopefully with increased flexibility on the side of the ECB.
McEldowney